TAX JUSTICE **BRIEFING**

COUNTRY-BY-COUNTRY REPORTING:
HOW TO MAKE MULTINATIONAL COMPANIES MORE TRANSPARENT

1 What is the general problem?

1.1 Tax avoidance is a worldwide problem. It involves the abusive exploitation of gaps and loopholes in domestic and international tax law that allows multinational companies (MNCs), in particular, to shift profits from country to country, often to or via tax havens, with the intention of reducing the tax they pay on some or all of their profits. Tax avoidance is legal, though it represents a direct challenge to the declared will of governments since it involves an attempt to avoid the tax laws they have created.

1.2 Worldwide, the tax not paid by these companies may amount to hundreds of billions of Euros a year. A recent study in the UK showed that UK corporations pay 75 per cent of the tax expected of them, at most[i]. To compensate for the lost tax revenues, governments must increase tax rates on local business and on individuals.

1.3 Tax avoidance on such a large scale worldwide is made easy by a lack of transparency in the way MNCs report and publish their accounts. Making MNC accounts more transparent would help tackle tax avoidance, and at very low cost. It would provide other benefits, such as improving democratic accountability, curbing crime and removing large and destabilising risks from the global financial markets.

1.4 All countries lose out from tax avoidance, but some suffer more than others. Poorer countries are most vulnerable: they rarely have the necessary resources and capacity to challenge MNCs trading in their countries. Poorer countries' public finances also often depend to a larger degree on corporate taxes than wealthier countries do, so tax avoidance by MNCs has proportionately greater impact on them.

1.5 The tax that corporations do not pay in poorer countries has to be replaced by aid or debt. These are poor substitutes for tax revenues. Tax generally builds relationships of accountability between rulers and citizens; aid and debt tend to make rulers more accountable to aid donors and foreign creditors. Stopping or curbing tax avoidance will allow governments to provide better services to their citizens or cut taxes for the majority, or both.

2. What is the specific problem?

2.1 The public accounts provided by MNCs represent the transactions of all the companies within the MNC group. In some cases this involves thousands of companies. However, the intra-group transactions, which are the basis for much tax avoidance, are not reported in the published accounts. Removing intra-group transactions from public view can make it impossible for tax authorities or anyone else to penetrate the accounts. This facilitates tax avoidance.

2.2 MNCs are required to publish segment information that breaks their trade down in ways that are meant to be useful to the users of their accounts. This does not, however, now require that they publish almost any geographic data, and there is no requirement to do so on a country-by-country basis. This is, as a result, almost never done.

2.3 Despite publishing their accounts as if they are unified entities, MNCs are not taxed in this way. Instead, each member company of the group is taxed individually. This makes it hard to establish an overview of what is happening within a group of companies for tax purposes, even within a single country. Companies frequently take advantage of this to avoid tax.

3. What mechanisms do they use?

3.1 The mechanisms used by companies to avoid their tax liabilities are often complex, but the principles are straightforward. The main objective of tax avoidance is to reduce a company's tax bill without breaking the law. This can be done by:

- **Finding and exploiting loopholes** in domestic tax laws. This is not the focus of this paper.
- **Adjusting a company's accounting** to reduce its tax bill: for example, by seeking to bring forward the time when an expense is charged in its accounts to reduce its taxable profits. This is also not the focus of this paper.
- **Shifting profits out of a country** with a higher tax rate and into a country with a lower tax rate. See Box 1, page 3.

4. Who is creating the problem?

4.1 Three sets of actors are involved in this profits shifting process:

- The companies undertaking the tax avoidance in this way;
- The accountants, lawyers and bankers who help MNCs by creating the schemes and mechanisms used for this purpose;
- The tax havens used for this purpose.

5. The role of tax havens

5.1 These jurisdictions deliberately create laws that allow companies and individuals to use legal entities such as trusts, companies and partnerships that are registered in the tax havens but which actually undertake little or no real trade there.

5.2 The purpose of these entities is to record transactions on which it is claimed that profits have arisen, even though the process by which they have been relocated is almost entirely artificial. In many cases the recording of the transaction in the tax haven makes no difference to the real transaction undertaken between the MNC and its suppliers or customers. In most cases the tax haven transaction will be undertaken on an entirely internal basis between members of the MNC, having tax avoidance as its sole or principal purpose.

5.3 Little or no tax is paid on the profits booked in these havens. Tax havens compete with each other to make sure that this can be the case.

6. How much is at stake?

6.1 The Organisation for Economic Cooperation & Development estimates that 60 per cent of all world trade is now undertaken on an intra-group basis, i.e. between companies under common control. When more than half of world trade is susceptible to transfer mispricing, or routing through tax havens, the risk of tax loss is enormous. Up to US$1 trillion of trade mispriced deals may take place a year to achieve tax savings.

6.2 The global value of tax lost is not known, but some national estimates are known. In the UK corporate tax avoidance is estimated to cost the government up to £12 billion (€16.5 billion) each year. The US Senate has cited estimates that the US tax authorities lose over $50 billion a year just to transfer pricing abuses (see Box 1). Worldwide the sums are much larger. The losses to tax avoidance must be significantly greater than what the **World Bank** and other have estimated are needed to fund the **Millennium Development Goals.**

Box 1: Profit shifting and transfer pricing

Companies shift profits in several ways. One is through **transfer mispricing**.

A transfer pricing arrangement occurs whenever two or more businesses (whether corporations or not) that are owned or controlled directly or indirectly by the same people trade with each other. Because the entities are owned in common this trade is not governed by market forces. Instead the owners can set prices that achieve another purpose, such as avoiding taxes.

If these prices are set properly, and are equivalent to those that independent third parties would have used they are called 'arms length' prices. Setting such prices within an MNC is an entirely legitimate part of international trade. However, when transfer prices are fixed artificially and incorrectly to achieve tax saving or other objectives the process is known as transfer mispricing.

Transfer mispricing can relate to:

The sale of goods such as raw materials and agricultural products.

The supply of services. It is much harder to determine the value of services than it is of goods. These might include management services, marketing services, group insurance services, and so on.

The supply of intellectual property: increasingly used for transfer mispricing. This involves registering a trademark, copyright or patent in an offshore location. It might be something as simple as a brand name or logo. Companies within the group are then charged for the use of the 'asset' that has been created in the tax haven location. The charge for use of this asset is claimed as a deduction for tax purposes in the accounts of a company where tax at normal prevailing rates is charged, but the income is recorded in the tax haven where the asset is supposedly located and where little or no tax is paid.

The supply of intra-group finance. MNCs frequently operate their group treasury functions in low tax jurisdictions such as Ireland and the Netherlands. These treasury units (which are effectively internally owned banks) provide loans to other MNC group members in higher-taxed locations, and charge these group members interest on the loans. The borrowers in the higher-taxed locations get tax relief on these interest payments. The interest is paid to the treasury function located in a tax haven, which as a result pays little or no taxes on that income. The net result is a tax saving achieved by shifting money within the group, but without providing a real benefit to the world in terms of a better or cheaper product.

For further explanation see:

http://www.taxresearch.org.uk/Blog/2007/08/10/transfer-pricing-2/

http://www.guardian.co.uk/flash/page/0,,2201916,00.html

7. How do companies get away with it?

7.1 Companies get away with tax avoidance for the following reasons:

- The tax haven structures created to promote these schemes are shrouded in secrecy. It is often impossible for a tax authority to obtain information or assistance from the government of a tax haven, and companies are not usually under any obligation to disclose what they are doing outside the country that is making the enquiry. Even securing enough information to prove that a tax avoidance scheme exists can be hard.
- Problems arise when trying to define the value of an intra-group transaction (such as that for the use of a brand name or logo) because there is no independent free market for that product which can set a bench-mark for pricing.
- It can take many years for tax avoidance schemes to be discovered.
- The accountants, lawyers and bankers who help companies create these schemes fiercely defend their legality.
- As described in Section 2, the current structure of company accounts hides the transactions used for these purposes from view, facilitating tax avoidance.
- Crucially, civil society groups around the world have paid little attention to this. Tax 'experts', who are often beholden to big businesses, have made or heavily influenced the rules that are currently in use. These rules are typically designed to favour their corporate clients and make life hard for tax authorities.

8 What can be done about this?

8.1 Various initiatives are underway to create rules for international taxation, and these must be pushed further. But securing agreement on a global set of tax rules is difficult because there is no world parliament or tax authority. International tax reforms are usually negotiated on a bilateral basis, not multilaterally, and the OECD member states and other rich nations tend to make deals between themselves, ignoring poorer countries. Some of the larger tax havens, like the UK and USA, are OECD member states, and most of the smaller tax haven jurisdictions, such as those associated with the UK and the Netherlands, are closely linked to OECD member states, so there is strong resistance to change.

8.2 Other options are available which would not require the painstaking construction of multilateral global tax agreements. One of the most promising is **country-by-country reporting**.

8.3 Country-by-country reporting could be introduced immediately by the **International Accounting Standards Board** (IASB), which sets accounting rules for the vast majority of MNCs. Since 2005 the **European Union** has effectively given the IASB's rules, called International Financial Reporting Standards (IFRS), the power of law throughout the Union. This is also the case in almost 100 countries, which figure is rising steadily: and the United States is on track to adopt them. They are fast becoming the global rules for accounting.

8.4 Although the IASB rejected country-by-country reporting when it was first promoted by the **Tax Justice Network** and the **Publish What You Pay Coalition**, others have the power to make it re-consider the issue. The **EU Parliament** said in 2007 that it wants the IASB to develop country-by-country reporting for the extractive industries, and it has the power to enforce this request. TJN wants that request extended to MNCs in all sectors.

9 What exactly is country-by-country reporting?

9.1 Country-by-country reporting means that an MNC would report in its accounts, without exception:

- Which countries it operates in;
- What name it trades under in each country;
- its financial performance in the countries where it operates, including:
  - sales, both within the group and outside the group

- purchases, split the same way;
- financing costs, split the same way;
- labour costs and employee numbers;
- pre-tax profit;
- tax payments to the government of the location where it is trading.

9.2 This information must reconcile with the company's main published accounts.

> **IMPORTANT NOTE:** Country-by-country reporting would impose little or no cost burden on MNCs because they already hold all the necessary data that we are asking to be disclosed for internal accounting purposes.

10 Who would benefit and how?

10.1 Country-by-country reporting would show where a group of companies operates, what name it trades under, and what trading it undertakes there, both within its own group and with third party suppliers and customers. This would make new information available to a wide range of stakeholder groups.

10.2 In particular it would put on record:

Where a company is registered and operates. This would highlight those operating in politically unstable regimes, tax havens, war zones and other sensitive areas. It would also help citizens of those jurisdictions find out who really owns the companies that are trading in their countries;

What tax is being paid where, whether that appears reasonable in relation to the tax rates in the country in question, and whether the group appears to be using tax havens for profits-shifting purposes. The use of tax havens will be highlighted both by the country listing and by data showing that intra-group trading in these places is particularly heavy. Heavy use of tax havens should trigger deeper enquiry into whether transfer mispricing is occurring.

10.3 Making this information available to a wider range of stakeholders would also strengthen efforts to monitor:

Corrupt practices, which are often disguised through the use of offshore special purpose vehicles;

Corporate governance. There has been a remarkable coincidence between major corporate failures and groups of companies making extensive use of offshore arrangements;

Tax payments to developing countries;

World trade flows. Data on the 60 per cent of world trade that takes place within MNCs is scarce and hard to understand;

Corporate responsibility. For example, employment conditions in all the countries where an MNC operates could be monitored.

11 By how much might stakeholders benefit?

Introducing a country-by-country reporting standard would potentially raise as much tax revenue in poor countries as has been estimated is needed to secure the Millennium Development Goals.

It is impossible to place a monetary value on the benefits of country-by-country reporting. But we can say with a high degree of confidence that no other measure could yield such a range of benefits with such ease and effectiveness, and with so little administrative cost.

> This briefing is based on a manuscript prepared by **Richard Murphy** (**Tax Research LLP**), which was revised and edited following comments from other members of the panel of experts responsible for this Series.

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i www.tuc.org.uk/touchstone/Missingbillions/1missingbillions.pdf